



April 2025

Defensive Equity Without the FOMO

Is it time to consult the Oracle of Delphi?

Executive Summary

Investors are understandably concerned about stretched equity market valuations, compressed risk premia, and geopolitical uncertainty. However, taking equity risk off the table can be costly for long-term returns and investors don't want the FOMO of missing a further bull market. What if we could turn to the Oracle of Delphi for guidance? In this short note, we discuss how you might be able to have your cake and eat it too - potentially earning equity-like returns with less risk.

Alfie Brixton

Executive Director, Portfolio Solutions Group

Jorge Fernandez-Cuervo

Executive Director, Business Development

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Inscribed at the entrance to the Temple of Apollo at Delphi in ancient Greece were three maxims. While it is unlikely that the Delphinians of millennia ago had any consideration for the concerns of the modern investor, we might still use these ancient maxims as a guide to navigate today's market challenges.

“Know Thyself”

The first maxim, “know thyself”, has been interpreted to mean understanding one’s limitations. If you’ll forgive the metaphorical leap, this could be construed as an appeal for investors to better understand their risk tolerance. The experience of the past 15 years has perhaps bred complacency regarding the risks inherent in equity markets. What drawdowns have occurred in 2011, 2020 and 2022, have been relatively shallow and, more importantly, short-lived. However, one doesn't have to look much further back to find more severe equity market drawdowns with much longer recovery times. Investors should ask themselves whether they are prepared to face a ~50% drawdown, as U.S. equity investors experienced during the Global Financial Crisis, or whether they could stomach the six-year period it took U.S. equity markets to recover from the burst of the tech bubble in the early 2000s. The first quarter of 2025 has seen a pull-back in equity markets on tariff policy uncertainty, but it’s difficult to predict where we go from here.¹

“Nothing in Excess”

The second maxim, “nothing in excess,” could serve as a warning against excess reliance on the equity risk premium. Equity valuations are

currently stretched and estimates of the equity risk premium appear compressed.² A look at history suggests lower expected returns from such rich valuations, see **Exhibit 1**, but any investor relying on this metric for market timing would have been disappointed in recent history as markets continued to richen – market timing is hard!

“A Pledge Brings Trouble”

The third maxim, “give a pledge and trouble is at hand,” can be interpreted as a word of caution against overconfidence. In particular, investors appear overconfident about future earnings growth and are willing to pay for outsized implied growth rates.³ We think this reflects a failure to appreciate the range of potential outcomes and a tendency of the market to over-extrapolate growth expectations, i.e., animal spirits are high. We would advocate caution and encourage diversification. While U.S. earnings growth has been strong, inflation has fallen, and unemployment remains low, potential catalysts for a shock to sentiment include geopolitical uncertainty around tariffs, trade wars, protectionism and unexpected developments in the artificial intelligence race (we have already seen several of these not-so-mythical beasts rearing their heads in 2025).

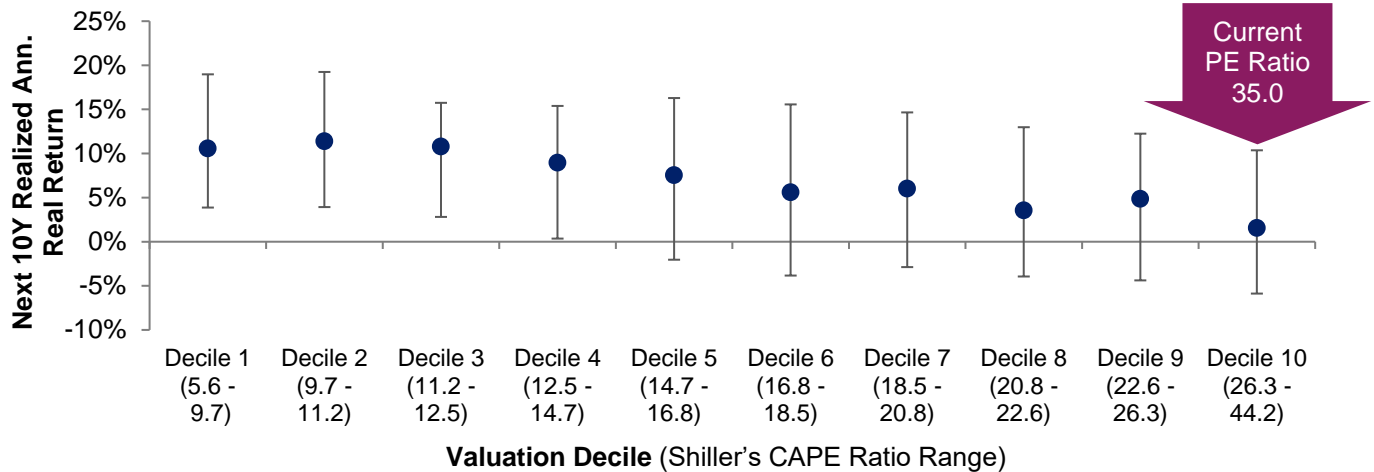
¹ Based on the S&P 500 Index.

² As we show in our Issue 1 2025 Alternative Thinking: *Capital Market Assumptions for Major Asset Classes*, expected returns on bonds and cash have increased from all-time low in 2021 but expected returns for equities have remained fairly constant – implying a compressed equity risk premium.

³ Refer to the special topic of our Issue 1 2025 Alternative Thinking: *Capital Market Assumptions for Major Asset Classes*.

Exhibit 1: Equity Valuations Matter for Prospective Returns

Distribution of Next 10Y U.S. Equity Returns by Starting Valuation Decile, Jan 1, 1926 – Mar 31, 2025



Source: AQR, Robert Shiller’s Data Library, Bloomberg, Ibbotson Associates. Chart shows the mean, maximum and minimum next 10-year realized annual geometric real return for U.S. Equity grouped by starting valuation decile. The valuation measure is Shiller’s CAPE (Cyclically Adjusted Price-to-Earnings Ratio) which is the ratio of the current price to past 10-year average earnings. U.S. Equity is represented by the S&P 500 Index, and prior to the inception of the index we use Ibbotson’s rendition of the S&P 500. Data is from January 1, 1926 – March 31, 2025. For illustrative purposes only. Please read important disclosures in the Appendix.

An Answer from the Oracle?

The risk averse among you might take this backdrop as a call to sell stocks. But the concerns we’ve described are not new, and such a contrarian view would have resulted in a costly sacrifice of equity beta over recent years, potentially leaving some investors feeling like the real risk was the risk of being left out.⁴

An investor in 2025 may like to ask the Oracle, “What should I do? Avoid equities in case the music (finally) stops? Or get onboard in the hope the party continues?” Unfortunately, Delphi’s Oracle will not respond (it has been out of service since AD 390).⁵ A satisfying middle ground could be to reduce risk while adding an alternative source of return that complements equity beta. This is where AQR’s own take on the Oracle, the AQR Delphi Long-Short Equity strategy (herein “Delphi LS”), comes in.

Delphi LS is a systematic long-short equity strategy that seeks to match or outperform the global equity market over the long term with around half the explicit market exposure. It goes long low-risk and high-quality stocks that have historically offered higher risk-adjusted returns, and short stocks with the opposite characteristics. Since its inception over twelve years ago, it has achieved its objective, delivering higher returns than global equity markets with less risk, as shown in **Exhibit 2**.⁶ In fact, Delphi LS has captured almost 70% of the equity market’s upside while experiencing less than 20% of its downside, as shown in **Exhibit 3**. If markets were a game of musical chairs, Delphi LS has allowed equity investors to keep dancing with one hand on the chair.

⁴ The S&P 500 Index returned 26% in 2023 and 25% in 2024 despite starting from high valuations.

⁵ Some may interpret the Q1 2025 pull-back in U.S. equity as the music beginning to stop while others view it as a buying opportunity.

⁶ Based on net returns for the Delphi Long-Short Equity Strategy from 11/1/2012 – 3/31/2025 net of 0.6% mgmt. fee and 15% performance fee over the Beta-Adjusted Benchmark (described in the disclosures). Past performance is not a reliable indicator of future performance.

Exhibit 2: AQR Delphi LS Has Delivered Equity-Like Returns with Less Risk⁷

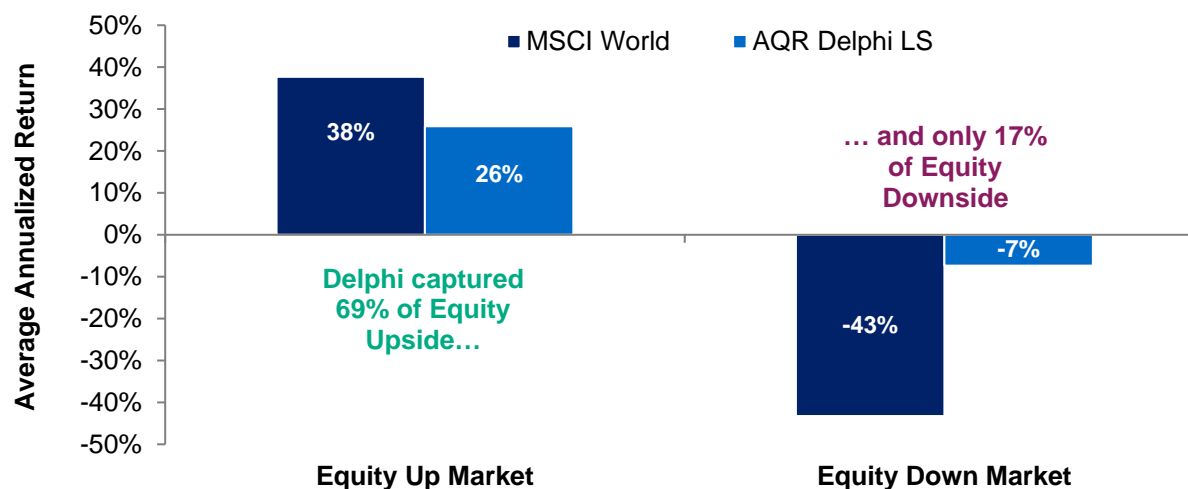
AQR Delphi Long-Short Equity Composite Net Returns, Nov 1, 2012 - Mar 31, 2025

| | Delphi Long-Short Equity Composite Net Returns | MSCI World Index |
|---|--|------------------|
| 1-Year | 19.8% | 7.0% |
| 3-Year (Ann.) | 16.6% | 7.6% |
| 5-Year (Ann.) | 15.7% | 16.1% |
| 7-Year (Ann.) | 13.0% | 10.2% |
| 10-Year (Ann.) | 14.8% | 9.5% |
| Summary (Since November 1, 2012) | | |
| Since Inception (Ann.) | 14.6% | 10.6% |
| Ann. Volatility | 11.9% | 14.1% |
| Sharpe Ratio | 1.1 | 0.6 |
| AQR Delphi LS Beta to Index | | 0.3 |

Source: AQR, Bloomberg. Delphi Long-Short Equity Composite returns represent unaudited net returns prepared by AQR. Net performance is calculated based on a 0.6% mgmt. fee and a 15% performance fee over the Beta-Adjusted Benchmark (described in the disclosures). Performance for most recent month end is estimated and subject to change. Past performance is not a reliable indicator of future performance. Please read important disclosures in the Appendix. Other discretionary portfolios that trade similar securities and/or strategies as those portfolios included in this composite, but do not meet this composite's strategy criteria, are excluded from this composite and reside in one or more separate composites, which are available upon request. The GIPS Composite Report for the Delphi Long-Short Equity Strategy can be found in the Appendix.

Exhibit 3: Delphi LS Has Captured Equity Upside Whilst Avoiding the Downside

Average Annualized Return in Equity Up and Down Markets, Nov 1, 2012 - Mar 31, 2025



Source: AQR, Bloomberg. Equity up and down markets are months when the MSCI World Index unhedged in USD return was positive or negative respectively. The chart shows the average annualized return in these periods. AQR Delphi LS is net returns for the AQR Delphi Long-Short Equity Composite. Net performance is calculated based on a 0.6% mgmt. fee and a 15% performance fee over the Beta-Adjusted Benchmark (described in the disclosures). Past performance is not a reliable indicator of future performance. Please read important disclosures in the Appendix.

⁷ We do not recommend benchmarking the Delphi LS strategy to global equity indices in the short term, due to meaningful expected tracking error. However, these indices can serve as useful gauges for the role Delphi LS can play in a broader portfolio.

What if the Music Continues?

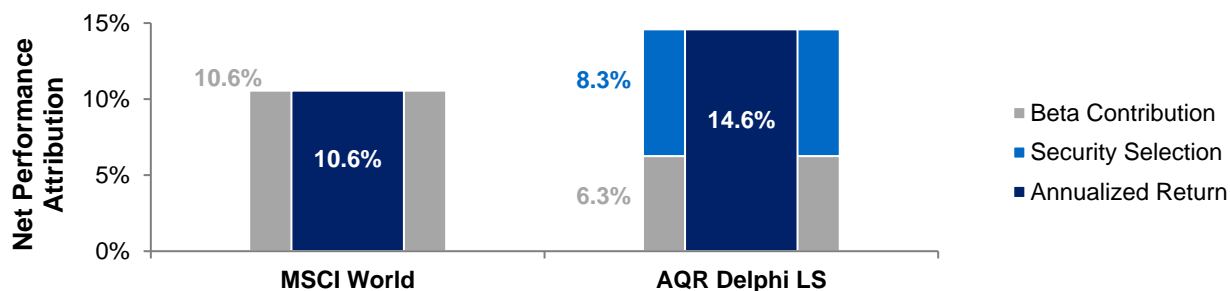
Despite targeting half the market exposure of a global equity portfolio, Delphi LS has delivered higher returns than the MSCI World Index since inception⁸ – a period of exceptionally strong equity performance. The alternative source of return has come from long/short stock selection that has delivered around 8% alpha per annum, as shown in **Exhibit 4**. This is achieved by following the underutilized investment philosophy of low-risk investing, favoring low statistical risk (low beta) and low fundamental risk (high quality) stocks, which has been used by another oracle – Warren Buffett – for decades, but is overlooked by many investors.⁹ We implement this whilst managing risk across many dimensions, including market beta, country, industry, and peer groups.¹⁰

What if the Music Stops?

One consequence of targeting around half the equity market exposure of the global equity market is that the Delphi LS strategy would be expected to suffer only around half as much in an equity drawdown. In addition, defensive stocks have tended to earn higher risk-adjusted returns on average and during drawdowns, which would provide an additional boost to Delphi LS – which favors these stocks.¹¹ This defensive return profile can be seen in action in **Exhibit 5**. Not only did the Delphi LS strategy outperform the market in all the largest equity drawdowns since its inception, it did better than its 0.5 beta would imply, due to positive contributions from stock selection over these periods.¹² The first quarter of 2025 is another example, with the MSCI World Index down -5.1% and Delphi LS up 5.1%.

Exhibit 4: Stock Selection Has Contributed Meaningful Alpha to Delphi LS's Returns

Delphi LS Net Attribution, Nov 1, 2012 - Mar 31, 2025



Source: AQR, Bloomberg. Chart shows the annualized performance of the MSCI World Index unhedged in USD, and net performance of the Delphi LS strategy split into the return driven by market exposure and the return driven by security selection. Market exposure is based on the Beta-Adjusted Benchmark (described in the disclosures). Data shown is for a representative account with a unique tracking error and account guidelines and may not be fully representative of other portfolios AQR may manage. Representative account was chosen as the account with the longest track record. Past performance is not a reliable indicator of future performance. Net attribution is calculated by allocating fees using strategic risk weights and with each component's return divided by sum of total returns for the portfolio. Fees and expenses are not charged to individual investments/sub-strategies, and net attribution is provided for illustrative purposes only to meet regulatory requirements. Different calculation methodologies can result in materially different net returns. Please refer to the strategy net performance, which best represents the net performance an investor would have received if they had invested in the strategy for the period shown.

^{8, 12} Based on net returns for the Delphi Long-Short Equity Strategy from 11/1/2012 – 3/31/2025 net of 0.6% mgmt. fee and 15% performance fee over the Beta-Adjusted Benchmark (described in the disclosures). Past performance is not a reliable indicator of future performance.

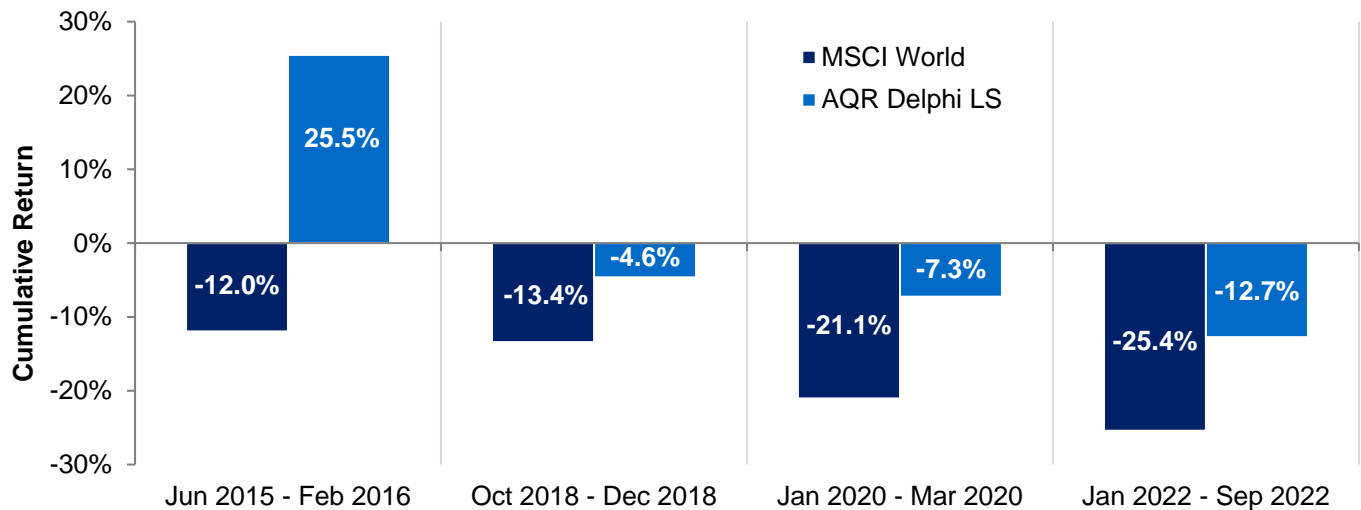
⁹ See “Buffett’s Alpha,” Frazzini, Kabiller, and Pedersen (2013) for details. Warren Buffet takes a long-only, discretionary, and concentrated approach, but the same themes can be applied in a systematic, diversified manner.

¹⁰ AQR has contributed meaningfully to the literature on this topic, see, for example, “Betting Against Beta,” Frazzini and Pedersen (2013), “Quality Minus Junk,” Asness, Frazzini and Pedersen (2015), and “Is Your Equity Hedge Fund Portfolio Resilient Enough for Uncertain Times?” Aghassi, Doheny, Fattouche, and Wong (2024).

¹¹ Note that low-risk investing can initially underperform during a market downturn if there is beta compression. Beta compression occurs when the performance differences between high-beta and low-beta stocks narrow, as investors sell indiscriminately during a crisis (e.g., in February 2020). However, this phenomenon tends to be short-lived.

Exhibit 5: Delphi LS Has Performed Better in Equity Downturns

Performance During Peak-to-Trough Drawdowns for Global Equity, Nov 1, 2012 – Mar 31, 2025



Source: AQR, Bloomberg. Chart shows cumulative total returns during peak-to-trough drawdowns greater than 10% for the MSCI World Index unhedged in USD. AQR Delphi LS is net returns for the AQR Delphi Long-Short Equity Composite. Net performance is calculated based on a 0.6% mgmt. fee and a 15% performance fee over the Beta-Adjusted Benchmark (described in the disclosures). Past performance is not a reliable indicator of future performance. Please read important disclosures in the Appendix.

Concluding Thoughts

The holy grail for equity investors is to participate in the upside of bull markets whilst protecting from the downside of drawdowns. This desire feels particularly acute at the start of 2025 with exciting new technologies on the one hand, but, on the other, equity market valuations near historic highs, a compressed equity risk premium, and a volatile geopolitical environment. Investors might wish for the Oracle of Delphi to illuminate the path ahead, but sadly such perfect foresight is limited to myth.

Perhaps the best advice any oracle could offer is to remind investors that, since the future is highly

uncertain, adopting approaches that are robust to multiple potential outcomes is the most realistic form of prescience. In other words, keep one hand on the musical chair.

The AQR Delphi Long-Short Equity strategy aims to provide investors with the best of both worlds. The strategy seeks to deliver equity like returns with less risk. Since its inception over 12 years ago, it has earned similar returns to equity markets while realizing lower risk, experiencing smaller drawdowns, and investing globally in thousands of stocks.¹³

¹³ Based on net returns for the Delphi Long-Short Equity Strategy from 11/1/2012 – 3/31/2025 net of 0.6% mgmt. fee and 15% performance fee over the Beta-Adjusted Benchmark (described in the disclosures). Past performance is not a reliable indicator of future performance.

References

- AQR *Alternative Thinking* 2025 Issue 1, “Capital Market Assumptions for Major Asset Classes” white paper.
- AQR *Whitepaper*, 2024, “Is Your Equity Hedge Fund Portfolio Resilient Enough for Uncertain Times?” white paper.
- Asness, C., A. Frazzini, and L. Pedersen, 2015, “Quality Minus Junk,” *Review of Accounting Studies*.
- Frazzini, A., and L. Pedersen, 2013, “Betting Against Beta,” *Journal of Financial Economics*.
- Frazzini, A., D. Kabiller, and L. Pedersen, 2013, “Buffett’s Alpha,” *The Financial Analysts Journal*.

Disclosures

Beta-Adjusted Benchmark: The Delphi Long-Short Equity Strategy performance fees are calculated relative to a beta-adjusted benchmark that accounts for the explicit market exposure that the strategy targets (investors shouldn’t pay a performance fee for passive market exposure). AQR made a change to the source of market exposure for the strategy in 2018 and therefore the beta-adjusted benchmark is represented by: a 45% weighting to MSCI World Total Return Unhedged Index in USD and 55% weighting to ICE BofA US 3-Mo T-Bill from 11/1/12 – 10/31/18, and a 50% weighting to MSCI World Net Total Return Hedged Index in USD and 50% weighting to ICE BofA US 3-Mo T-Bill from 11/1/18 onwards.

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| Year | Gross Return % | Net Return 1 % | Net Return 2 % | Net Return 3 % | Benchmark * Return % | Number of Portfolios | Composite 3-Yr StDev % | Benchmark * 3-Yr StDev % | Composite Assets (\$M) | Total Firm Assets (\$M) |
|------|----------------|----------------|----------------|----------------|----------------------|----------------------|------------------------|--------------------------|------------------------|-------------------------|
| 2012 | -4.82 | -5.04 | -4.91 | -4.93 | 1.46 | 1 | N/A | N/A | 9.17 | 71,122.42 |
| 2013 | 18.53 | 16.91 | 17.83 | 16.47 | 11.41 | 1 | N/A | N/A | 12.72 | 98,302.69 |
| 2014 | 19.54 | 17.90 | 16.49 | 16.85 | 2.32 | 1 | N/A | N/A | 15.42 | 122,655.99 |
| 2015 | 27.72 | 25.97 | 22.90 | 24.16 | -0.15 | 1 | 13.05 | 4.82 | 13.54 | 142,173.39 |
| 2016 | 16.85 | 15.24 | 14.29 | 14.47 | 3.71 | 1 | 12.80 | 4.88 | 13.61 | 175,089.36 |
| 2017 | 29.09 | 27.33 | 25.60 | 25.47 | 10.08 | 1 | 12.53 | 4.58 | 15.27 | 223,432.52 |
| 2018 | 3.26 | 1.83 | 1.77 | 2.48 | -3.22 | 2 | 11.20 | 4.77 | 24.28 | 193,554.78 |
| 2019 | 22.12 | 20.45 | 20.42 | 19.38 | 14.85 | 2 | 10.46 | 5.28 | 100.27 | 185,575.93 |
| 2020 | -3.75 | -5.09 | -4.33 | -4.42 | 8.06 | 2 | 12.87 | 8.59 | 306.10 | 139,714.13 |
| 2021 | 37.27 | 35.41 | 34.93 | 33.24 | 11.72 | 2 | 14.68 | 7.99 | 456.59 | 123,007.08 |
| 2022 | -5.33 | -6.65 | -6.04 | -5.99 | -6.87 | 2 | 16.30 | 9.49 | 481.10 | 93,980.30 |
| 2023 | 18.42 | 16.79 | 17.24 | 17.18 | 14.51 | 2 | 13.40 | 7.69 | 687.84 | 97,876.68 |

*Custom Benchmark: 45% MSCI World Unhedged / 55% ICE BofA US 3-Month Treasury Bill Index from inception through October 2018. Beginning November 2018, 50% MSCI World 100% Hedged to USD Net Total Return Index / 50% ICE BofA US 3-Month Treasury Bill Index

Net Return 1 calculated based on 1.40% management fee per annum.

Net Return 2 calculated from inception through October 2018 based on 0.60% management fee and 15.00% performance fee (over 45% MSCI World Unhedged / 55% ICE BofA US 3-Month Treasury Bill Index hurdle) per annum. Beginning November 2018, calculated based on 0.60% management fee and 15.00% performance fee (over 50% MSCI World Hedged to USD Net Total Return / 50% ICE BofA US 3-Month Treasury Bill Index hurdle) per annum.

Net Return 3 calculated based on 0.70% management fee and 10% performance fee (over ICE BofA US 3-Month Treasury Bill Index hurdle) per annum.

Composite Description: The Delphi Long-Short Equity Composite (the "Composite") was created in November 2012. The investment objective of the Composite strategy (the "Strategy") is to provide capital appreciation. The Firm will target a beta of approximately 0.5 to global equity markets and targets a long-term average annualized tracking error of 10% relative to its beta-adjusted Benchmark. The Strategy pursues its investment objective by seeking to invest on a long basis in attractively valued, high quality and low beta assets, and on a short basis in expensive, low quality and high beta assets. The Composite is denominated in USD.

Stock Selection strategies primarily do not utilize leverage as part of the Strategy's active investment strategy, and primarily do not use derivatives for leverage. For portfolio management purposes, the Strategy may use equity index futures, swaps, and/or currency forwards to equitize flows or for security-specific implementation efficiency to minimize transaction costs. In certain cases, the Strategy may also use derivatives as a tool for implementing country- or currency-specific overlay views. For these portfolios, the currency forwards and country-level equity index futures are implemented with the intention of expressing an active investment strategy. However, for strategies that do not explicitly trade country and currency selection models, derivatives typically represent only a more efficient means of gaining and managing risk exposures.

Benchmark: Beginning November 2018, the Composite benchmark is a custom blended benchmark rebalanced daily and weighted approximately 50% MSCI World 100% Hedged to USD Net Total Return Index and 50% ICE BofA US 3-Month Treasury Bill Index (the "Benchmark"). The MSCI World 100% Hedged to USD Net Total Return Index represents a close estimation of the performance that can be achieved by hedging the currency exposures of its parent index, the MSCI World Index, to the USD, the "home" currency for the hedged index. The index is 100% hedged to the USD by selling each foreign currency forward at the one-month forward weight. The parent index is designed to measure the equity market performance of 23 developed markets' country indices throughout the world. The ICE BofA US 3-Month Treasury Bill Index measures the rate of return an investor would realize when purchasing a single U.S. 3-month treasury bill, holding it for one month, selling it, and rolling it into a newly selected issue at the beginning of the next month. From inception through October 2018, the custom benchmark was weighted approximately 45% MSCI World and 55% ICE BofA US 3-Month Treasury Bill Index. Additional information on AQR's custom benchmarks is available upon request.

Fees & Expenses: Composite net of fees returns are calculated by deducting the maximum model management or advisory fee AQR could charge from the composite monthly gross returns. AQR's asset-based fees for portfolios within the Composite may range up to 1.40% of assets under management and are generally billed monthly or quarterly at the commencement of the calendar month or quarter during which AQR will perform the services to which the fees relate. Composite assets may have been exposed to the impact of performance fees. This management fee is applicable for AQR Delphi Long-Short Equity Master Account, L.P., which had an estimated expense ratio as of December 31, 2023 of 0.13% per annum.

Past performance is not an indication of future performance.



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